SCOTTS LIQUID GOLD INC
Form 10-Q
May 14, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2015

Or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number: 001-13458

SCOTT'S LIQUID GOLD-INC.

(Exact name of registrant as specified in its charter)

Colorado	84-0920811
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
	80239

4880 Havana Street, Suite 400, Denver, CO	
(Address of principal executive offices)	(Zip Code)

303-373-4860

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act. Yes ¨ No x

As of May 14, 2015, the Registrant had 11,635,039 of its common stock, $0.10 par value per share, outstanding.

CAUTIONARY NOTE ON FORWARD-LOOKING INFORMATION

This Quarterly Report on Form 10-Q (this “Report”) contains “forward-looking statements” within the meaning of U.S. federal securities laws. All statements, other than statements of historical fact, included in this Report that address activities, events, or developments with respect to our financial condition, results of operations, or economic performance that we expect, believe, or anticipate will or may occur in the future, or that address plans and objectives of management for future operations, are forward-looking statements. You can typically identify forward-looking statements by the use of words, such as “may,” “could,” “should,” “assume,” “project,” “believe,” “anticipate,” “expect,” “esti “potential,” “plan,” and other similar words. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements and our performance inherently involve risk and uncertainty that could cause actual results to differ materially from the forward-looking statements. Factors that would cause or contribute to such differences include, but are not limited to:

- changing consumer preferences and the continued acceptance of each of our significant products in the marketplace;
- the degree of success of any new product or product line introduction by us, including our Scott’s Liquid Gold® Floor Restore product, which we introduced late in the fourth quarter of 2013;
- competitive factors, including any decrease in distribution of (i.e., retail stores carrying) our significant products;
- continuation of our distributorship agreements for Montagne Jeunesse skin care products and Batiste Dry Shampoos;
- the need for effective advertising of our products and limited resources available for such advertising;
- new competitive products and/or technological changes;
- dependence upon third party vendors and upon sales to major customers;
- the availability of necessary raw materials and potential increases in the prices of these raw materials;
- changes in the regulation of our products, including applicable environmental and U.S. Food and Drug Administration (“FDA”) regulations;
- the continuing availability of financing on terms and conditions that are acceptable to us;
- future losses which could affect our liquidity;
- the loss of any executive officer; and
- other matters discussed in this Report, including the risks described in the Risk Factors section of this Report.

We caution you that forward-looking statements are not guarantees of future performance and that actual results or performance may be materially different from those expressed or implied in the forward-looking statements. The forward-looking statements in this Report speak as of the filing date of this Report. Although we may from time to time voluntarily update our prior forward-looking statements, we undertake no obligation to revise any forward-looking statements in order to reflect events or circumstances that may arise after the date of this Report.

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PART I

ITEM 1. FINANCIAL STATEMENTS.
Consolidated Statements of Operations (Unaudited)

Scott's Liquid Gold-Inc. & Subsidiaries

	Three Months Ended March 31,	
	2015	2014
Net sales	$6,948,200	$5,483,800
Operating costs and expenses:		
Cost of sales	3,739,400	2,976,600
Advertising	247,200	199,600
Selling	1,353,200	1,132,500
General and administrative	909,200	670,500
Total operating costs and expenses	6,249,000	4,979,200
Income from operations	699,200	504,600
Other income	4,100	8,600
Interest expense	(7,300)	(7,200)
Income before income taxes	696,000	506,000
Income tax expense	12,400	8,400
Net income	$683,600	$497,600
Net income per common share		
Basic	$0.06	$0.04
Diluted	$0.06	$0.04
Weighted average shares outstanding:		
Basic	11,557,281	11,446,800
Diluted	11,874,589	11,662,496

See accompanying notes to these Consolidated Financial Statements (Unaudited).

Consolidated Balance Sheets

Scott's Liquid Gold-Inc. & Subsidiaries

	March 31, 2015 (unaudited)	December 31, 2014
Assets		
Current assets:		
Cash and cash equivalents	$6,045,600	$5,896,600
Trade receivables, net	2,028,900	1,041,100
Inventories, net	2,946,100	2,689,700
Income taxes receivable	0	3,700
Prepaid expenses	342,900	346,000
Total current assets	11,363,500	9,977,100
Property, plant and equipment, net	368,700	400,800
Other assets	51,000	51,000
Total assets	$11,783,200	$10,428,900
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	1,210,200	616,300
Accrued payroll and benefits	729,500	665,900
Income taxes payable	2,900	0
Accrued property taxes	20,400	34,200
Total current liabilities	1,963,000	1,316,400
Total liabilities	1,963,000	1,316,400
Shareholders' equity:		
Common stock; $0.10 par value, authorized 50,000,000 shares; issued and outstanding 11,576,539 shares (2015) and 11,549,789 shares (2014)	1,157,700	1,155,000
Capital in excess of par	5,735,200	5,713,800
Retained earnings	2,927,300	2,243,700
Total shareholders' equity	9,820,200	9,112,500
Total liabilities and shareholders' equity	$11,783,200	$10,428,900

See accompanying notes to these Consolidated Financial Statements (Unaudited).

Consolidated Statements of Cash Flows (Unaudited)

Scott's Liquid Gold-Inc. & Subsidiaries

	Three Months Ended March 31, 2015	2014
Cash flows from operating activities:		
Net income	$683,600	$497,600
Adjustment to reconcile net income to net cash used by operating activities:		
Depreciation and amortization	39,500	35,800
Stock-based compensation	17,200	17,500
Change in operating assets and liabilities:		
Trade receivables	(987,800)	(561,600)
Inventories	(256,400)	170,500
Prepaid expenses and other assets	3,100	55,900
Income taxes (receivable) payable	6,600	8,400
Accounts payable and accrued expenses	643,700	(330,100)
Total adjustments to net income	(534,100)	(603,600)
Net Cash Provided (Used) by Operating Activities	149,500	(106,000)
Cash flow from investing activities:		
Purchase of property, plant and equipment	(7,400)	(9,900)
Net Cash Used by Investing Activities	(7,400)	(9,900)
Cash flow from financing activities:		
Proceeds from exercise of stock options	6,900	0
Net Cash Provided by Financing Activities	6,900	0
Net Increase (Decrease) in Cash and Cash Equivalents	149,000	(115,900)
Cash and Cash Equivalents, beginning of period	5,896,600	3,126,200
Cash and Cash Equivalents, end of period	$6,045,600	$3,010,300
Supplemental disclosures:		
Cash paid during the period for interest	$7,300	$7,200

See accompanying notes to these Consolidated Financial Statements (Unaudited).

Notes to Consolidated Financial Statements (Unaudited)

Scott's Liquid Gold-Inc. & Subsidiaries

Note 1. Organization and Summary of Significant Accounting Policies.

(a) Company Background

Scott's Liquid Gold-Inc. (a Colorado corporation) was incorporated on February 15, 1954. Scott's Liquid Gold-Inc. and its wholly-owned subsidiaries (collectively, the "Company", "we", "our", or "us") develop, manufacture, market and sell quality household and skin and hair care products. We are also a distributor in the United States of Montagne Jeunesse skin sachets and Batiste Dry Shampoo manufactured by two other companies. Our business is comprised of two segments, household products and skin and hair care products.

(b) Principles of Consolidation

Our consolidated financial statements include our accounts and those of our wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated.

(c) Basis of Presentation

The Consolidated Statements of Operations, Consolidated Balance Sheets, and the Consolidated Statements of Cash Flows included in this Report have been prepared by the Company. In our opinion, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position at March 31, 2015 and results of operations and cash flows for all periods have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. These consolidated financial statements should be read in conjunction with our financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2014. The results of operations for the period ended March 31, 2015 are not necessarily indicative of the operating results for the full year.

(d) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts in our financial statements of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include, but are not limited to, the realization of deferred tax assets, reserves for slow moving and obsolete inventory, customer returns and allowances, and stock-based compensation. Actual results could differ from our estimates.

(e) Cash Equivalents

We consider all highly liquid investments with an original maturity of three months or less at the date of acquisition to be cash equivalents.

(f) Sale of Accounts Receivable

On November 3, 2008, effective as of October 31, 2008, we entered into a financing agreement with Summit Financial Resources, L.P. ("Summit") for the purpose of providing working capital. The financing agreement with Summit was amended on March 12, 2009, March 16, 2011 (effective March 1, 2011) and June 29, 2012 (effective July 1, 2012). The agreement has a term that expires on January 1, 2016, but it may be renewed for additional 12 month periods unless either party elects to cancel in writing at least 60 days prior to January 1, 2016 and thereafter on the anniversary date of each 12 month period.

The agreement provides for a factoring line up to $1.5 million and is secured primarily by accounts receivables, inventory, any lease in which we are a lessor and all investment property and guarantees by our active subsidiaries. Under the agreement, Summit will make loans at our request and in its discretion based on: (i) its purchases of our receivables, with recourse against us, at an advance rate of 85% (or such other percentage determined by Summit in its discretion) and (ii) our inventory not to exceed certain amounts, including an aggregate maximum of $500,000. Advances under the agreement have an interest rate of 1.0% over the prime rate (as published in The Wall Street Journal) for the accounts receivables portion of the advances and 2.5% over the prime rate for the inventory portion of the borrowings. At March 31, 2015, the prime rate was 3.25%.

There is also an administrative fee of 0.85% per month on the average monthly outstanding loan on the receivable portion of any advance if the average quarterly loan in the prior quarter was less than or equal to $1,000,000, and 0.75% per month if the average quarterly loan in the prior quarter was greater than $1,000,000 and of 1.0% per month on the average monthly outstanding loan on the inventory portion of any advance.

The agreement provides that neither we nor our active subsidiaries may engage in a change in control transaction without the prior written consent of Summit. Events of default include, but are not limited to, our failure to make a payment when due or a default occurring on any of our other indebtedness.

In 2015 and 2014, we did not sell any of our accounts receivables to Summit. At March 31, 2015 and December 31, 2014 the entire credit line of $1.5 million was available for future factoring of accounts receivable invoices and borrowings secured by our inventory.

We report these transactions using the authoritative guidance of the Financial Accounting Standards Board (“FASB”) as a secured borrowing rather than as a sale. As a result, affected accounts receivable are reported under the “Current Assets” section within our Consolidated Balance Sheets as “Trade receivables, net.” Similarly, the net liability owing to Summit, if any, appears as “Obligations collateralized by receivables and inventory” within the “Current Liabilities” section of our Consolidated Balance Sheets. Net proceeds received on obligations collateralized by receivables and inventory appear as “net cash provided (used) by operating activities” within the “Adjustment to reconcile net income to net cash used by operating activities” section of our Consolidated Statements of Cash Flows.

On March 16, 2011, with the consent of Summit, we entered into a financing agreement with Wells Fargo Bank, National Association (“Wells Fargo”) for the purpose of further lowering the cost of borrowing associated with the financing of our accounts receivable. Pursuant to this agreement, we may sell accounts receivables from one of our largest customers, Wal-Mart Stores, Inc. (“Wal-Mart”), at a discount to Wells Fargo; provided, however, that Wells Fargo may reject offers to purchase such receivables in its discretion. These receivables may be purchased by Wells Fargo at a cost to us equal to LIBOR plus 1.15% per annum. The LIBOR rate used depends on the days to maturity of the receivable sold, typically ranging from 102 to 105 days. At March 31, 2015, Wells Fargo used the 104-day LIBOR rate of 0.32%.

The agreement has no fixed termination date, but continues unless terminated by either party giving 30 days prior written notice to the other party. During the three months ended March 31, 2015 and 2014, we sold approximately $1,055,000 and $1,038,900, respectively, of our relevant accounts receivable to Wells Fargo for approximately $1,050,600 and $1,034,700, respectively. The difference between the invoiced amount of the receivable and the cash that we received from Wells Fargo is a cost to us. This cost is in lieu of any cash discount our customer would have been allowed and, thus, is treated in a manner consistent with standard trade discounts granted to our customers.

The reporting of the sale of accounts receivables to Wells Fargo is treated as a sale rather than as a secured borrowing. As a result, affected accounts receivables are relieved from the Company’s financial statements upon receipt of the cash proceeds.

(g) Inventories

Inventories consist of raw materials and finished goods and are stated at the lower of cost (first-in, first-out method) or market. We record a reserve for slow moving and obsolete products and raw materials. We estimate this reserve based upon historical and anticipated sales.

Inventories were comprised of the following at:

	March 31, 2015	December 31,2014
Finished goods	$1,948,800	$ 1,626,300
Raw materials	1,051,700	1,117,800
Inventory reserve for obsolescence	(54,400)	(54,400)
	$2,946,100	$ 2,689,700

(h) Property, Plant and Equipment

Property, plant and equipment are recorded at historical cost. Depreciation is provided using the straight-line method over the estimated useful lives of the assets ranging from three to 20 years. Production equipment and production support equipment are estimated to have useful lives of 15 to 20 years and three to 10 years, respectively. Office furniture and office machines are estimated to have useful lives of 10 to 20 years and three to five years, respectively. Carpets, drapes and company vehicles are estimated to have useful lives of five to 10 years. Maintenance and repairs are expensed as incurred. Improvements that extend the useful lives of the asset or provide improved efficiency are capitalized.

(i) Financial Instruments

Financial instruments which potentially subject us to concentrations of credit risk include cash and cash equivalents and trade receivables. We maintain our cash balances in the form of bank demand deposits with financial institutions that we believe are creditworthy. As of March 31, 2015, and periodically throughout the year, we have maintained balances in various operating accounts in excess of federally insured limits. We establish an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and other information. We have no significant financial instruments with off-balance sheet risk of accounting loss, such as foreign exchange contracts, option contracts or other foreign currency hedging arrangements.

The recorded amounts for cash and cash equivalents, receivables, other current assets, accounts payable and accrued expenses approximate fair value due to the short-term nature of these financial instruments. As of March 31, 2015 and December 31, 2014 we had no long-term debt.

(j) Income Taxes

We follow FASB authoritative guidance for the accounting for income taxes which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective income tax bases. A valuation allowance is provided when it is more likely than not that some portion or all of a deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the period in which related temporary differences become deductible. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

Taxes are reported based on tax positions that meet a more-likely-than-not standard and that are measured at the amount that is more-likely-than-not to be realized. Differences between financial and tax reporting which do not meet this threshold are required to be recorded as unrecognized tax benefits or expense. We classify penalty and interest expense related to income tax liabilities as an income tax expense. There are no significant interest and penalties recognized in the statement of operations or accrued on the balance sheet. The Company’s information returns for tax years subject to examination by tax authorities include 2011 and 2012 through the current period for state and federal tax reporting purposes, respectively.

(k) Revenue Recognition

Our revenue recognition policy is significant because the amount and timing of revenue is a key component of our results of operations. We follow guidance issued by FASB, which requires that certain criteria be met in order to recognize revenue. If these criteria are not met, then the associated revenue is deferred until it is met. In our case, the criteria generally are met when we have an arrangement to sell a product, we have delivered the product in accordance with that arrangement, the sales price of the product is determinable and we believe that we will be paid for the sale.

We establish reserves for customer returns of our products and customer allowances. We estimate these reserves based upon, among other things, an assessment of historical trends, information from customers and anticipated returns related to current sales activity. These reserves are established in the period of sale and reduce our revenue in that period.

Our reserve for customer allowances includes primarily reserves for trade promotions to support price features, displays, slotting fees and other merchandising of our products to our customers. The actual level of returns and customer allowances is influenced by several factors, including the promotional efforts of our customers, changes in mix of our customers, changes in the mix of the products we sell and the maturity of the product. We may change our estimates based on actual results and consideration of other factors that cause returns and allowances. In the event that actual results differ from our estimates, the results of future periods may be impacted.

We also establish reserves for coupons, rebates and certain other promotional programs for consumers. We estimate these reserves based upon, among other things, an assessment of historical trends and current sales activity. These reserves are recorded as a reduction of revenue at the later of the date at which the revenue is recognized or the date at which the sale incentive is offered.

We have also established an allowance for doubtful accounts. We estimate this allowance based upon, among other things, an assessment of the credit risk of specific customers and historical trends. We believe our allowance for doubtful accounts is adequate to absorb any losses which may arise. In the event that actual losses differ from our estimates, the results of future periods may be impacted.

At March 31, 2015 and December 31, 2014 approximately $599,300 and $795,300, respectively, had been reserved as a reduction of accounts receivable. Trade promotions to our customers and incentives such as coupons to our consumers are deducted from gross sales and totaled $510,100 and $529,800 for the three months ended March 31, 2015 and 2014, respectively.

(l) Advertising Costs
Advertising costs are expensed as incurred.

(m) Stock-based Compensation
During the three months ended March 31, 2015 and 2014, we did not grant any stock options.

Compensation cost related to stock options recognized in operating results (included in general and administrative expenses) under authoritative guidance issued by the FASB was $17,200 and $17,500 in the three months ended March 31, 2015 and 2014, respectively. Approximately $225,300 of total unrecognized compensation costs related to non-vested stock options is expected to be recognized over the next 48 – 60 months, depending on the vesting provisions of the options. In accordance with this same authoritative guidance, there was no tax benefit from recording the non-cash expense as it relates to the options granted to employees, as these were qualified stock options which are not normally tax deductible. With respect to the non-cash expense associated with options granted to the non-employee directors, no tax benefit is recognized due to the existence of as yet unutilized net operating losses. At such time as these operating losses have been utilized and a tax benefit is realized from the issuance of non-qualified stock options, a corresponding tax benefit may be recognized.

(n) Operating Costs and Expenses Classification
Cost of sales includes costs associated with manufacturing and distribution including labor, materials, freight-in, purchasing and receiving, quality control, internal transfer costs, repairs, maintenance and other indirect costs, as well as warehousing and distribution costs. We classify shipping and handling costs comprised primarily of freight-out as selling expenses. Other selling expenses consist primarily of wages and benefits for sales and sales support personnel,

travel, brokerage commissions and promotional costs, as well as certain other indirect costs. Shipping and handling costs totaled $344,000 and $354,500 for the three months ended March 31, 2015 and 2014, respectively.

General and administrative expenses consist primarily of wages and benefits associated with management and administrative support departments, business insurance costs, professional fees, office facility related expenses, and other general support costs.

(o) Recently Issued Accounting Standards

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606)” (“ASU 2014-09”). ASU 2014-09 amends the guidance for revenue recognition to replace numerous industry-specific requirements and converges areas under this topic with those of the International Financial Reporting Standards. The ASU implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. The amendment also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts and customers. Other major provisions include the capitalization and amortization of certain contract costs, ensuring the time value of money is considered in the transaction price, and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain circumstances. The amendments in this ASU are effective for reporting periods beginning after December 15, 2016, and early adoption is prohibited. Entities can transition to the standard either retrospectively or as a cumulative-effect adjustment as of the date of the adoption. We are currently assessing the impact, if any, that the adoption of ASU 2014-09 will have on our financial statements.

Note 2. Earnings per Share.

We present basic and diluted earnings or loss per share in accordance with authoritative guidance which establishes standards for computing and presenting basic and diluted earnings per share. Per share data is determined by using the weighted average number of common shares outstanding. Common equivalent shares are considered only for diluted earnings per share, unless considered anti-dilutive. Common equivalent shares, determined using the treasury stock method, result from stock options with exercise prices that are below the average market price of the common stock.

Basic earnings per share include no dilution and are computed by dividing income available to common shareholders by the weighted-average number of shares outstanding during the period. Diluted earnings per share reflect the potential of securities that could share in our earnings. There were common stock equivalents of 397,500 and 110,000 shares outstanding at March 31, 2015 and 2014, respectively, consisting of stock options that were not included in the calculation of earnings per share because they would have been anti-dilutive.

A reconciliation of the weighted average number of common shares outstanding for the three months ended March 31, 2015 and 2014 is as follows:

	2015	2014	
Common shares outstanding, beginning of the year	11,549,789	11,446,800	
Weighted average common shares issued	7,492	0	
Weighted average number of common shares outstanding	11,557,281	11,446,800	
Dilutive effect of common share equivalents	317,308	88	$ (1)

State and municipal bonds	16,619	(430)	---	---	16,619	(430)
Other equity securities	992	(8)	---	---	992	(8)
Total temporarily impaired	$ 17,699	$ (439)	$---	$---	$ 17,699	$ (439)

There were no sales of securities for the three and nine month periods ended September 30, 2009 and the three month period ended September 30, 2008. Proceeds from the sale of available for sale securities were $21,704,000 and resulted in gross gains of $412,000 for the nine months ended September 30, 2008.

Other-Than-Temporary-Impairment

Management evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Investment securities classified as available for sale or held-to-maturity are generally evaluated for OTTI under ASC Topic 320, *Investments Debt and Equity Instruments*.

NOTE 2 SECURITIES (Continued)

In determining OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If an entity intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment s amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

For unrealized losses on securities at September 30, 2009 and December 31, 2008, no loss has been recognized into income because management has the intent and ability to hold these securities for the foreseeable future and the declines are largely due to differences in market interest rates as compared to those of the underlying securities. The declines in fair value are considered temporary and are expected to recover as the bonds approach their maturity date.

NOTE 3 LOANS

Loans were as follows (in thousands):

	September 30, 2009	December 31, 2008
Commercial and industrial	$ 375,636	$ 451,826
Commercial real estate	834,664	927,633
Total commercial	1,210,300	1,379,459
Residential mortgage	166,960	203,954
Consumer	179,643	190,650
	1,556,903	1,774,063
Allowance for loan losses	(48,049)	(38,262)
	$ 1,508,854	$ 1,735,801

NOTE 3 LOANS (Continued)

Activity in the allowance for loan losses was as follows (in thousands):

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Balance at beginning of period	$ 37,621	$ 29,579	$ 38,262	$ 33,422
Provision for loan losses	21,580	2,425	52,740	23,585
Charge-offs	(11,758)	(1,869)	(44,380)	(27,090)
Recoveries	606	356	1,427	574
Balance at end of period	$ 48,049	$ 30,491	$ 48,049	$ 30,491

Impaired loans were as follows at period end (dollars in thousands):

	September 30, 2009	December 31, 2008
Loans with no allocated allowance for loan losses	$ 69,142	$ 49,922
Loans with allocated allowance for loan losses	93,769	102,015
	162,911	151,937
Amount of the allowance for loan losses allocated	$ 25,480	$ 20,008

	Nine months ended September 30, 2009	Nine months ended September 30, 2008
Average of impaired loans during the period	$ 157,062	$ 118,801
Interest income recognized during impairment	3,200	1,663
Cash received for interest during impairment	2,923	1,422

Nonperforming loans were as follows at period-end (dollars in thousands):

	September 30, 2009	December 31, 2008
Loans past due over 90 days still on accrual	$ 4,749	$ 3,200
Nonaccrual loans	83,411	89,049
	$ 88,160	$ 92,249

NOTE 4 OTHER REAL ESTATE OWNED

Period-end other real estate owned was as follows (dollars in thousands):

	September 30, 2009	December 31, 2008
Other real estate owned, initial balanced transferred in	$ 36,640	$ 21,135
Less: valuation allowance	(3,221)	(1,619)
	$ 33,419	$ 19,516

Activity in the valuation allowance was as follows (dollars in thousands):

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Beginning balance	$ 2,963	$ 978	$ 1,619	$ 147
Additions charged to expense	547	462	2,402	1,317
Deletions upon disposition	(289)	(273)	(800)	(297)
Ending balance	$ 3,221	$ 1,167	$ 3,221	$ 1,167

Net realized gains on sales of other real estate were $4,000 and $113,000 for the three and nine month periods ended September 30, 2009. Net realized losses on sales of other real estate were $71,000 and $211,000 for the three and nine month periods ended September 30, 2008.

NOTE 5 FAIR VALUE

ASC Topic 820, *Fair Value Measurements and Disclosures*, establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels of inputs that may be used to measure fair value include:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Investment Securities: The fair values of investment securities are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities relationship to other benchmark quoted securities (Level 2 inputs).

Loans Held for Sale: The fair value of loans held for sale is based upon binding quotes from 3rd party investors (Level 2 inputs)

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NOTE 5 FAIR VALUE (Continued)

Impaired Loans and Other Real Estate Owned: The fair value of collateral dependent impaired loans with specific allocations of the allowance for loan losses and other real estate owned with a valuation allowance are generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available (Level 3 inputs).

Assets and liabilities measured at fair value on a recurring basis are summarized below (in thousands):

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
September 30, 2009				
U.S. federal agency securities	$ 88,007	$ ---	$ 88,007	$ ---
State and municipal bonds	52,803		52,803	
Other equity securities	1,015		1,015	
Loans held for sale	2,934	---	2,934	---
December 31, 2008				
Available for sale securities	$ 184,681	$ ---	184,681	$ ---
Loans held for sale	2,261	---	2,261	---

Assets and liabilities measured at fair value on a non-recurring basis are summarized below (in thousands):

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
September 30, 2009				
Impaired loans	$ 54,560	$ ---	$ ---	$ 54,560
Other real estate owned	31,160	---	---	31,160
December 31, 2008				
Impaired loans	$ 39,272	$ ---	$ ---	$ 39,272

The following represent impairment charges recognized during the period:

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $57.3 million and $42.9 million with a valuation allowance of $2.7 million and $3.6 million at September 30, 2009 and December 31, 2008, respectively. An additional provision for loan losses of approximately $7.3 million and $2.2 million was recorded on these loans for the three month periods ended September 30, 2009 and 2008, respectively. An additional provision for loan losses of approximately $23.8 million and $11.1 million was recorded on these loans for the nine month periods ended September 30, 2009 and 2008, respectively.

NOTE 5 FAIR VALUE (Continued)

Other real estate owned measured using the fair value of collateral, had a carrying amount of $36.6 million with a valuation allowance of $3.2 million at September 30, 2009. Additional writedowns of approximately $547,000 and $2.4 million were recorded on these properties for the three and nine month periods ended September 30, 2009.

The carrying amounts and estimated fair values of financial instruments, at September 30, 2009 and December 31, 2008 are as follows (dollars in thousands).

	September 30, 2009		**December 31, 2008**	
	Carrying Amount	**Fair Value**	**Carrying Amount**	**Fair Value**
Financial assets				
Cash and cash equivalents	$ 169,968	$ 169,968	$ 68,284	$ 68,284
Securities available for sale	141,825	141,825	184,681	184,681
Securities held to maturity	655	675	1,835	1,867
FHLB stock	12,275	N/A	12,275	N/A
Loans held for sale	2,934	2,934	2,261	2,261
Loans, net	1,508,854	1,508,471	1,735,801	1,709,672
Accrued interest receivable	7,243	7,243	7,746	7,746
Bank-owned life insurance	24,165	24,165	23,645	23,645
Financial liabilities				
Deposits	(1,546,311)	(1,556,582)	(1,665,761)	(1,678,591)
Other borrowed funds	(288,023)	(293,065)	(284,790)	(292,198)
Subordinated debt	(1,650)	(1,650)	---	---
Long-term debt	(41,238)	(34,299)	(41,238)	(34,906)
Accrued interest payable	(2,346)	(2,346)	(4,366)	(4,366)
Off-balance sheet credit-related items	---	---	---	---

The methods and assumptions used to estimate fair value are described as follows. Carrying amount is the estimated fair value for cash and cash equivalents, short-term borrowings, accrued interest receivable and payable, bank-owned life insurance, demand deposits, short-term debt, and variable rate loans or deposits that reprice frequently and fully. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Fair value of debt is based on current rates for similar financing. The fair value of off-balance sheet credit-related items is not significant. The methods for determining fair value of securities, impaired loans and loans held for sale were described previously. It was not practicable to determine the fair value of stock due to restrictions placed on its transferability.

NOTE 6 DEPOSITS

Deposits are summarized as follows (in thousands):

	September 30, 2009	**December 31, 2008**
Noninterest-bearing demand	$ 221,967	$ 192,842
Interest bearing demand	261,648	230,091
Savings and money market accounts	380,672	411,369
Certificates of deposit	682,024	831,459
	$ 1,546,311	$ 1,665,761

NOTE 6 DEPOSITS (Continued)

Approximately $401,234,000 and $574,861,000 in certificates of deposit were in denominations of $100,000 or more at September 30, 2009 and December 31, 2008.

Brokered deposits totaled approximately $236,796,000 and $337,768,000 at September 30, 2009 and December 31, 2008. At September 30, 2009 and December 31, 2008, brokered deposits had interest rates ranging from 3.50% to 4.55% and 3.25% to 4.90%, respectively. At September 30, 2009, maturities for brokered deposits were as follows (in thousands):

Due in one year or less	$	169,963
Due from one to two years		63,177
Due from two to three years		3,656
	$	236,796

NOTE 7 EARNINGS PER COMMON SHARE

A reconciliation of the numerators and denominators of basic and diluted earnings (loss) per common share for the three and nine month periods ended September 30, 2009 and 2008 are as follows (dollars in thousands, except per share data):

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Net income (loss)	$ (19,883)	$ 1,871	$ (54,433)	$ (3,797)
Dividends declared on preferred shares	(991)	---	(2,869)	---
Net income (loss) available to common shares	$ (20,874)	$ 1,871	$ (57,302)	$ (3,797)
Weighted average shares outstanding, including participating stock awards - Basic	17,669,440	17,022,393	17,365,840	17,013,386
Dilutive potential common shares:				
Stock options	---	22,586	---	---
Conversion of preferred stock	---	---	---	---
Weighted average shares outstanding - Diluted	17,669,440	17,044,979	17,365,840	17,013,386
Basic earnings (loss) per common share	$ (1.18)	$ 0.11	$ (3.30)	$ (0.22)
Diluted earnings (loss) per common share (1)	(1.18)	0.11	(3.30)	(0.22)

(1) For any period in which a loss is recorded, the assumed exercise of stock options would have an anti-dilutive impact on loss per share and thus are ignored in the diluted per common share calculation.

NOTE 7 EARNINGS PER COMMON SHARE (Continued)

Stock options for 960,571 shares of common stock for both the three and nine month periods ended September 30, 2009 and stock options for 940,119 and 1,067,612 shares of common stock for the three and nine month periods ended September 30, 2008 were not considered in computing diluted earnings per share because they were antidilutive. Potential common shares associated with convertible preferred stock were excluded from dilutive potential common shares as they were antidilutive.

NOTE 8 FEDERAL INCOME TAXES

The consolidated provision (benefit) for income taxes was as follows (dollars in thousands):

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Current	$ (410)	$ 1,397	$ (7,512)	$ (2,612)
Deferred (benefit) expense	(6,994)	(758)	(11,396)	(481)
Change in valuation allowance	6,804	---	21,694	---
	$ (600)	$ 639	$ 2,786	$ (3,093)

The difference between the financial statement tax expense (benefit) and the amount computed by applying the statutory federal tax rate to pretax income (loss) was reconciled as follows (dollars in thousands):

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Statutory rate	35%	35%	35%	35%
Statutory rate applied to income (loss) before taxes	$ (7,169)	$ 879	$ (18,076)	$ (2,412)
Add (deduct)				
Change in valuation allowance	6,804	---	21,694	---
Tax-exempt interest income	(167)	(166)	(503)	(493)
Bank-owned life insurance	(82)	(86)	(360)	(248)
Other, net	14	12	31	60
	$ (600)	$ 639	$ 2,786	$ (3,093)

We periodically assess the need for a valuation allowance against deferred tax assets. The realization of deferred tax assets (net of a recorded valuation allowance) is largely dependent upon future taxable income, future reversals of existing taxable temporary differences and the ability to carryback losses to available tax years. In assessing the need for a valuation allowance, we consider all positive and negative evidence, including taxable income in carry-back years, scheduled reversals of deferred tax liabilities, expected future taxable income and tax planning strategies.

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NOTE 8 FEDERAL INCOME TAXES (Continued)

At September 30, 2009, we concluded the need for a valuation allowance based primarily on our net operating loss for 2008, our net operating loss for the first nine months of 2009 and the challenging operating environment currently confronting banks that could impact future operating results. As a result, we recorded a $21.7 million valuation allowance on deferred tax assets at September 30, 2009 that was charged to federal income tax expense. The valuation allowance may be reversed to income in future periods to the extent that the related deferred tax assets are realized or the valuation allowance is no longer required.

The net deferred tax asset recorded included the following amounts of deferred tax assets and liabilities (dollars in thousands):

	September 30, 2009	December 31, 2008
Deferred tax asset		
Allowance for loan losses	$ 16,817	$ 13,392
Nonaccrual loan interest	215	368
Valuation allowance on other real estate owned	1,127	567
Net operating loss carryforward	6,283	---
Tax credit carryforwards	551	---
Other	1,518	910
Gross deferred tax assets	26,511	15,237
Valuation allowance	(21,694)	---
Total net deferred tax assets	4,817	15,237
Deferred tax liabilities		
Depreciation	(2,142)	(2,227)
Purchase accounting adjustments	(232)	(306)
Unrealized gain on securities available for sale	(1,557)	(1,367)
Prepaid expenses	(473)	(490)
Other	(413)	(359)
Gross deferred tax liabilities	(4,817)	(4,749)
Net deferred tax asset	$ ---	$ 10,488

Realization of deferred tax assets associated with net operating loss carryforwards is dependent upon generating sufficient taxable income prior to their expiration. At September 30, 2009, the Company had a net operating loss carryforward of approximately $18.0 million which, if not used against taxable income, will expire in 2029.

There were no unrecognized tax benefits at September 30, 2009. The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months. The Company is no longer subject to examination by the Internal Revenue Service for years before 2006.

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NOTE 9 CONTINGENCIES

The Company and its subsidiaries periodically become defendants in certain claims and legal actions arising in the ordinary course of business.

As previously disclosed, the Company and Macatawa Bank entered into a Settlement and Release and Stock and Warrant Issuance Agreement and amendments (as amended, the Settlement Agreement) in connection with the legal proceedings related to Trade Partners, Inc. The settlement with respect to approximately 91% of the number of plaintiffs and the aggregate amount of their claims was completed and became effective on June 17, 2009. On July 27, 2009, the Company completed a second settlement with additional plaintiffs representing approximately 8.7% of the total number of original plaintiffs.

Including both the June 17 and July 27 settlements, the Company paid a total of $5.91 million for the cash portion of the settlement and issued Warrants to purchase a total of 1,478,811 shares of common stock at an exercise price of $9.00 per share. The Company s insurers contributed $950,000 to the $5.91 million cash portion of the settlement. Both the June 17 and July 27 settlements were expensed in the quarter ended June 30, 2009 and reduced the Company s net income by $5.5 million ($3.6 million on an after-tax basis).

Following the June 17 and July 27 settlements all plaintiffs have either settled with the Company or have been dismissed. The settlements resulted in the Company eliminating 100% of its potential liability with respect to the Trade Partners litigation.

The Settlement Agreement did not contain any admission of liability or wrongdoing by the Company or Macatawa Bank. The offer to settle was made in an attempt to avoid exposure to future litigation and to avoid the cost of litigation.

As of the date hereof, except as disclosed above, there were no material pending legal proceedings, other than routine litigation incidental to the business of banking to which we or any of our subsidiaries are a party of or which any of our properties are the subject.

NOTE 10 SHAREHOLDERS EQUITY

Regulatory Capital

The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If the Bank is only adequately capitalized, regulatory approval is required to accept brokered deposits; and if the Bank is undercapitalized, capital distributions are limited, as is asset growth and expansion, and plans for capital restoration are required.

NOTE 10 SHAREHOLDERS EQUITY (Continued)

At September 30, 2009 and December 31, 2008, actual capital levels and minimum required levels were (in thousands):

	Actual		Minimum Required For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2009						
Total capital (to risk weighted assets)						
Consolidated	$ 157,101	9.5%	$ 132,862	8.0%	N/A	N/A
Bank	154,519	9.3	132,622	8.0	$ 165,778	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	125,805	7.6	66,431	4.0	N/A	N/A
Bank	133,449	8.1	66,311	4.0	99,467	6.0
Tier 1 capital (to average assets)						
Consolidated	125,805	6.3	79,840	4.0	N/A	N/A
Bank	133,449	6.7	79,713	4.0	99,641	5.0
December 31, 2008						
Total capital (to risk weighted assets)						
Consolidated	$ 209,553	11.3%	$ 148,835	8.0%	N/A	N/A
Bank	198,922	10.7	148,611	8.0	$ 185,764	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	186,112	10.0	74,417	4.0	N/A	N/A
Bank	175,516	9.5	74,306	4.0	111,458	6.0
Tier 1 capital (to average assets)						
Consolidated	186,112	8.8	85,101	4.0	N/A	N/A
Bank	175,516	8.3	84,997	4.0	106,246	5.0

Approximately $31.5 million and $40.0 million of trust preferred securities outstanding at September 30, 2009 and December 31, 2008 qualified as Tier 1 capital. Refer to the Company s Form 10-K as of December 31, 2008 for more information on the trust preferred securities.

The Bank was categorized as adequately capitalized at September 30, 2009 and well capitalized at December 31, 2008. There are no conditions or events since September 30, 2009 that management believes have changed its category. The Bank s total regulatory capital was $11.3 million below the level required to be well capitalized at September 30, 2009.

Since the Bank was adequately capitalized at September 30, 2009, regulatory approval is required to accept brokered deposits. The Bank has not issued brokered deposits since November of 2008 and does not plan to increase brokered deposits but rather continue to reduce its level of brokered deposits throughout 2010. A maturity table of deposits issued through brokers is included in the deposit footnote.

Effective January 1, 2010, the interest rate paid for deposits by institutions that are less than well capitalized will be limited to 75 basis points above the national rate for similar products unless the institution can support to the FDIC that prevailing rates in its market area exceed the national average. The Company does not expect this requirement to impact its current deposit gathering activities.

NOTE 10 SHAREHOLDERS EQUITY (Continued)

Under the State of Michigan Banking Code, the Bank is also restricted from paying dividends to the Holding Company until its deficit retained earnings has been restored. The Bank had a retained deficit of approximately $14.7 million at September 30, 2009.

Issuance of Capital

During the second quarter of 2009, the Company began a private offering to accredited investors that included three capital instruments: Series B Non-Cumulative Perpetual Convertible Preferred Stock (Series B Preferred Stock), common stock and subordinated notes. This followed a previously disclosed offering closed in the fourth quarter of 2008 in which Series A Preferred Stock was sold resulting in net proceeds of $30.6 million. See the Notes to the financial statements included in the Company s SEC Form 10-K as of December 31, 2008 for further information regarding the Series A Preferred Stock. A summary of the capital instruments is as follows:

Convertible Preferred Stock

In the second and third quarters of 2009, the Company issued 2,600 shares of 9% Series B Preferred Stock with a liquidation preference of $1,000 per share, resulting in an aggregate liquidation preference of $2.6 million.

Each share of the Series B Preferred Stock is non-voting and may be convertible at any time, at the option of the holder, into 166.67 shares of common stock of the Company, which represents an approximate initial conversion price of $6.00 per share of common stock. On or after the third anniversary of the issue date, at the option of the Company, the Series B Preferred Stock will be subject to mandatory conversion into common stock at the prevailing conversion rate, if the closing price of the Company s common stock exceeds 120% of the then applicable conversion price for 20 trading days during any 30 consecutive trading day period and the Company has paid full dividends on the Series B Preferred Stock for four consecutive quarters. The conversion rate and conversion price will be subject to adjustments in certain circumstances. The Series B Preferred Stock is subordinate to the Series A Preferred Stock.

Both the Series A and Series B Preferred Stock qualified as Tier I capital for the Company.

If all of the outstanding shares of the Series A and Series B Preferred Stock were converted into common stock, the shares of Series A and Series B Preferred Stock would convert into a total of approximately 3.9 million shares of common stock at September 30, 2009.

On August 20, 2009, the board of directors declared a quarterly cash dividend on the Series A Preferred Stock of $30.00 per share. The dividend is payable October 30, 2009 to shareholders of record on September 15, 2009.

Common Stock

In the second and third quarters of 2009, the Company issued 538,386 shares of common stock to accredited investors as part of the private offering. The shares were issued at an average price of $3.06 per share resulting in total proceeds of $1.7 million.

Subordinated Notes

In the second and third quarters of 2009, the Company received proceeds of $1,650,000 from the issuance of subordinated debt. The subordinated debt was in the form of 11% subordinated notes due 2017. The subordinated notes qualified as Tier 2 capital for the Company and are not convertible into common stock or preferred stock.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

Macatawa Bank Corporation is a Michigan corporation and is the holding company for a wholly owned subsidiary, Macatawa Bank and for two trusts, Macatawa Statutory Trust I and Macatawa Statutory Trust II. Macatawa Bank is a Michigan chartered bank with depository accounts insured by the Federal Deposit Insurance Corporation. The bank operates twenty-six branch offices and a lending and operational service facility, providing a full range of commercial and consumer banking and trust and brokerage services in Kent County, Ottawa County, and northern Allegan County, Michigan. Macatawa Statutory Trusts I and II are grantor trusts and issued $20.0 million each of pooled trust preferred securities. These trusts are not consolidated in the Company s financial statements. For further information regarding consolidation, see the Notes to the Consolidated Financial Statements included herein.

Since opening in November of 1997, Macatawa Bank has generally experienced rapid growth. We believe that growth in core deposits is key to our long-term success and it is our primary funding source for asset growth. Establishing a branching network in our markets has been of high importance in order to facilitate this core deposit growth. We have and continue to enjoy success in building new and existing relationships through our branch network in the Holland/Zeeland, greater Grand Rapids and Grand Haven markets. We have gained community awareness and acceptance in our markets through our branch network and high quality service standards.

Up until the end of 2007, the West Michigan markets within which we operate have historically provided significant expansion opportunities. The weak local and national economic conditions that have persisted during this time have resulted in slower growth or contraction within most industry segments within our markets. These poor economic conditions within our markets have contributed to the decline in our financial performance and asset quality. Accordingly, we have slowed our overall asset growth to focus on improving our financial condition, including asset quality amidst the weak economic conditions in West Michigan. When economic conditions and our financial performance improve, we will again assess the prospects for future branch expansion and growth in our balance sheet.

RESULTS OF OPERATIONS

Summary: Net loss available to common shares for the quarter ended September 30, 2009 was $20.9 million, compared to third quarter 2008 net income of $1.9 million. Loss per common share on a diluted basis was $1.18 for the third quarter of 2009 compared to earnings per common share of $0.11 for the same period in 2008. Net loss available to common shares for the nine months ended September 30, 2009 was $57.3 million compared to a net loss of $3.8 million for the same period in the prior year. Loss per common share on a diluted basis was $3.30 for the nine months ended September 30, 2009 compared to $0.22 for the same period in the prior year.

Both the three and nine month periods ended September 30, 2009 were significantly impacted by the cost associated with problem loans and non-performing assets. The provision for loan losses remained elevated and was $21.6 million and $52.7 million for the three and nine months ended September 30, 2009 compared to $2.4 million and $23.6 million for the three and nine months ended September 30, 2008. Costs associated with nonperforming assets were $3.1 million and $7.7 million for the three and nine months ended September 30, 2009 compared to $1.6 million and $3.4 million for the three and nine months ended September 30, 2008. Lost interest from rising balances of non-performing assets was approximately $2.2 million and $6.8 million for the three and nine months ended September 30, 2009 compared to $1.4 million and $4.1 million for the three and nine months ended September 30, 2008. Each of these items is discussed more fully below.

The decrease in net income for the three months ended September 30, 2009 compared to the same period in 2008 was also partly due to an additional $6.8 million non-cash charge included in federal income tax expense to increase the valuation allowance for deferred tax assets.

The decrease in net income for the nine months ended September 30, 2009 compared to the same period in the prior year was also partly due to a non-cash charge of $21.7 million included in federal income tax expense to associated with the valuation allowance for deferred tax assets, a $5.5 million one-time charge associated with the settlement of the Trade Partners lawsuit and a $960,000 special FDIC assessment.

Net Interest Income: Third quarter net interest income totaled $13.2 million, a decrease of $1.6 million as compared to the third quarter of 2008. Net interest income for the first nine months of 2009 totaled $39.4 million, a decrease of $5.2 million as compared to $44.6 million for the same period in 2008.

The decrease in net interest income for both the three and nine month periods was primarily from a decline in the fully taxable equivalent net interest income as a percentage of average interest-earning assets (i.e. net interest margin or margin). As customary in the banking industry, interest income on tax-exempt securities is adjusted in the computation of the yield on tax-exempt securities and net interest margin using a 35% tax rate to report these items on a fully taxable equivalent basis.

The net interest margin decreased 15 basis points to 2.83% for the third quarter of 2009 and 26 basis points to 2.75% for the first nine months of 2009 when compared to the same periods in the prior year. The net interest margin has steadily improved during 2009 despite the pressure from higher balances of non-performing assets; from 2.66% in the first quarter to 2.79% in the second quarter to 2.83% in the third quarter.

Approximately 16 basis points of the decline in margin or $1.1 million of the decrease in net interest income, and 19 basis points of the decline in margin or $2.8 million of the decrease in net interest income, respectively, for the three and nine month periods was from lost interest from higher balances of non-performing assets and interest reversals on loans moved into a non-accrual status. Also contributing to the margin decline for the nine month period was the Federal funds and prime rate cuts that occurred throughout 2008.

Average earning assets decreased $113.6 million to $1.87 billion for the third quarter of 2009 and $55.4 million to $1.92 billion for the nine month period ended September 30, 2009 compared to the same periods of the prior year.

During both the three and nine month periods, the decrease in the yield on earning assets exceeded the decrease in the cost of interest bearing funds and was the primary reason for the decline in the net interest margin. The yield on earning assets decreased by 72 basis points for the three months ended September 30, 2009 and 90 basis points for the nine months ended September 30, 2009 compared to the same periods in the prior year. The short-term interest rate cuts that began in the third quarter of 2007 and continued throughout 2008 caused a decrease in the yield on our variable rate loan portfolio and was the primary reason for the decrease in yield on earning assets. The decline was also impacted by an increase in lower yielding short-term investments and rising balances of non-accrual loans. The Company has chosen to hold excess investable funds in these lower yielding short-term investments to improve its balance sheet liquidity during the current economic downturn.

The rising balances of non-accrual loans throughout 2008 and into 2009 resulted in additional decline in the yield on earning assets of approximately 12 and 14 basis points, respectively, for the three and nine months ended September 30, 2009 compared to the same periods in the prior year. Average non-accrual loans were $96.7 million and $73.5 million for the three month periods ended September 30, 2009 and 2008, resulting in an estimated reduction of 39 basis points and 27 basis points, respectively, in the yield on earning assets for each period. Average non-accrual loans were $101.3 million and $75.6 million for the nine month periods September 30, 2009 and 2008, resulting in an estimated reduction of 40 basis points and 26 basis points, respectively, in the yield on earning assets for each period.

The cost of funds decreased 57 basis points for the three months ended September 30, 2009 and 67 basis points for the nine months ended September 30, 2009 compared to the same periods in the prior year. A decrease in the rates paid on our deposit accounts in response to declining market rates, the rollover of time deposits at lower rates, and the rollover and repositioning of other borrowings within the lower rate environment were the primary reasons for the decrease in the cost of funds.

The level of earning assets is expected to decline in the near term due to the persistent weak economic conditions in Michigan. A continued decline in the cost of funds, primarily from the repricing of term funding at lower costs, is expected to continue to have a positive impact on net interest income throughout the remainder of 2009.

The following table shows an analysis of net interest margin for the three month periods ending September 30, 2009 and 2008.

	For the three months ended September 30,					
	2009			2008		
	Average Balance	Interest Earned or paid	Average Yield or cost	Average Balance	Interest Earned or paid	Average Yield or cost
	(Dollars in thousands)					
Assets						
Taxable securities	$ 101,553	$ 1,002	3.94%	$ 114,099	$ 1,210	4.24%
Tax-exempt securities (1)	51,144	537	6.47%	51,355	542	6.49%
Loans (2)	1,602,454	21,737	5.33%	1,757,839	26,388	5.90%
Federal Home Loan Bank stock	12,275	99	3.17%	12,275	164	5.22%
Federal funds sold and other short-term investments	103,569	159	0.61%	48,979	310	2.48%
Total interest earning assets (1)	1,870,995	23,534	5.01%	1,984,547	28,614	5.73%
Noninterest earning assets:						
Cash and due from banks	25,035			27,947		
Other	105,385			129,571		
Total assets	$ 2,001,415			$ 2,142,065		
Liabilities						
Deposits:						
Interest bearing demand	246,135	323	0.52%	$ 240,791	594	0.98%
Savings and money market accounts	393,508	627	0.63%	438,250	1,654	1.50%
Time deposits	697,965	6,367	3.62%	785,680	7,595	3.84%
Borrowings:						
Other borrowed funds	280,057	2,657	3.71%	296,254	3,328	4.39%
Long-term debt	41,238	366	3.48%	41,238	600	5.69%
Federal funds purchased	---	---	---%	1,284	7	2.26%
Total interest bearing liabilities	1,658,903	10,340	2.46%	1,803,497	13,778	3.03%
Noninterest bearing liabilities:						
Noninterest bearing demand accounts	216,520			176,266		
Other noninterest bearing liabilities	8,305			10,083		
Shareholders' equity	117,687			152,219		
Total liabilities and shareholders' equity	$ 2,001,415			$ 2,142,065		
Net interest income		$ 13,194			$ 14,836	
Net interest spread (1)			2.55%			2.70%
Net interest margin (1)			2.83%			2.98%
Ratio of average interest earning assets to average interest bearing liabilities	112.79%			110.04%		

(1) Yield adjusted to fully tax equivalent using a 35% tax rate.
(2) Includes non-accrual loans of approximately $96.7 million for the three months ended September 30, 2009 and approximately $73.5 million for the three months ended September 30, 2008.

The following table shows an analysis of net interest margin for the nine month periods ending September 30, 2009 and 2008.

	For the nine months ended September 30,					
	2009			2008		
	Average Balance	Interest Earned or paid	Average Yield or cost	Average Balance	Interest Earned or paid	Average Yield or cost
			(Dollars in thousands)			
Assets						
Taxable securities	$ 112,020	$ 3,368	4.01%	$ 131,620	$ 4,350	4.41%
Tax-exempt securities (1)	51,393	1,618	6.46%	51,400	1,627	6.49%
Loans (2)	1,674,124	67,581	5.34%	1,763,110	82,287	6.15%
Federal Home Loan Bank stock	12,275	291	3.13%	12,275	491	5.25%
Federal funds sold and other short-term investments	73,437	331	0.60%	20,218	375	2.44%
Total interest earning assets (1)	1,923,249	73,189	5.10%	1,978,623	89,130	6.00%
Noninterest earning assets:						
Cash and due from banks	23,507			27,216		
Other	108,947			124,420		
Total assets	$ 2,055,703			$ 2,130,259		
Liabilities						
Deposits:						
Interest bearing demand	$ 237,249	1,078	0.61%	$ 250,971	2,448	1.30%
Savings and money market accounts	404,027	2,194	0.73%	413,605	5,629	1.82%
Time deposits	756,778	21,127	3.73%	761,409	23,683	4.15%
Borrowings:						
Other borrowed funds	275,243	8,165	3.91%	314,925	10,562	4.42%
Long-term debt	41,238	1,237	3.95%	41,238	1,970	6.28%
Federal funds purchased	68	---	---%	9,548	217	2.98%
Total interest bearing liabilities	1,714,603	33,801	2.63%	1,791,696	44,509	3.30%
Noninterest bearing liabilities:						
Noninterest bearing demand accounts	197,754			168,465		
Other noninterest bearing liabilities	7,137			9,811		
Shareholders' equity	136,209			160,287		
Total liabilities and shareholders' equity	$ 2,055,703			$ 2,130,259		
Net interest income		$ 39,388			$ 44,621	
Net interest spread (1)			2.47%			2.70%
Net interest margin (1)			2.75%			3.01%
Ratio of average interest earning assets to average interest bearing liabilities	112.17%			110.43%		

(1) Yield adjusted to fully tax equivalent using a 35% tax rate.
(2) Includes non-accrual loans of approximately $101.3 million for the nine months ended September 30, 2009 and approximately $75.6 million for the nine months ended September 30, 2008.

Provision for Loan Losses: The provision for loan losses for the three and nine month periods ended September 30, 2009 was $21.6 million and $52.7 million compared to $2.4 million and $23.6 for the same periods in the prior year. The provision for loan losses remained elevated as we respond to continued declines in real estate values due to the prolonged weakness in the economy and its impact on our loan portfolio, primarily residential land development loans. The $19.2 million and $29.1 million increase in the provision for loan losses for the three and nine month periods ended September 30, 2009 related primarily to higher levels of net charge-offs and additional reserve requirements for impaired loans associated with these declines in real estate values. A decline in total portfolio loans during these periods partially offset the increase in the provision.

The amounts of loan loss provision in both the current and prior year period were a byproduct of establishing our allowance for loan losses at levels deemed necessary in our methodology for determining the adequacy of the allowance. For more information about our allowance for loan losses and our methodology for establishing its level, see the discussion below under Portfolio Loans and Asset Quality.

Noninterest Income: Noninterest income for the three and nine month periods ended September 30, 2009 decreased to $3.6 million and $13.2 million, respectively, from $4.1 million and $14.2 million for the same periods in the prior year. Non-interest income for the nine month period ended September 30, 2008 included approximately $412,000, $243,000 and $832,000, respectively, of gains on the sale of securities, gains on the termination of certain borrowings and gains on the settlement of interest rate swaps.

Declines in revenue from deposit, trust and brokerage services during the third quarter of 2009 were the primary reasons for the $504,000 decline in noninterest income compared to the same period in the prior year. Revenue from deposit, trust and brokerage services was also down for the first nine months of 2009 compared to the same periods in the prior year. The decline in revenue from deposit services is related to a decrease in non-sufficient fund revenue, consistent with a decline across the entire banking industry. This decline was partially offset by an increase in other revenue sources from continued growth in core checking accounts and expansion of services to business customers. The decline in trust and brokerage service revenue is related to both a challenging market for account growth and retention and volatility in equity market valuations.

Increases in net gains from mortgage lending activities that happened in the first half of 2009 and revenue from ATM and debit card processing for the nine month period ended September 30, 2009 offset the declines in revenue noted above when compared to the same period in the prior year. The decline in mortgage rates that began in the first quarter of 2009 led to a significant increase in refinancing activity and is the primary reason for the $1.3 million increase in net gains on mortgage loans for the nine months ended September 30, 2009 compared to the same periods in the prior year.

Noninterest Expense: Noninterest expense for the three and nine month periods ended September 30, 2009 increased to $15.7 million and $51.5 million, respectively, from $14.0 million and $42.1 million for the same periods in the prior year. The increase for the nine month period ended September 30, 2009 included a $5.5 million one-time charge associated with the Trade Partners litigation settlement discussed in the Notes to the financial statements.

For the three and nine month periods ended September 30, 2009 costs associated with nonperforming assets increased to $3.1 million and $7.7 million, respectively, from $1.6 million and $3.4 million for the same periods in the prior year. Costs associated with nonperforming assets include legal costs, repossessed and foreclosed property administration expense and losses on repossessed and foreclosed properties. Repossessed and foreclosed property administration expense includes survey and appraisal, property maintenance and management and other disposition and carrying costs. Losses on repossessed and foreclosed properties include both net losses on the sale of properties and subsequent reductions from value declines for outstanding properties.

These costs are itemized in the following table (in thousands):

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Legal and professional	$ 348	$ 153	$ 1,016	$ 359
Repossessed and foreclosed property administration	2,215	898	4,307	1,402
Losses on repossessed and foreclosed properties	565	515	2,403	1,667
Total	$ 3,128	$ 1,566	$ 7,726	$ 3,428

FDIC assessments increased by $671,000 to $1.0 million for the third quarter of 2009 compared to $359,000 for the third quarter of 2008 and by $2.4 million to $3.5 million for the nine month period ended September 30, 2009 compared to the same period in the prior year. The increase for the nine month period includes an industry-wide special assessment, which amounted to $960,000 for Macatawa Bank. The remaining increase in FDIC assessments was from higher assessment rates implemented by the FDIC in late 2008.

When excluding the Trade Partners litigation settlement charge, nonperforming asset costs and FDIC assessments, non-interest expense would have been approximately $11.6 million for the three month period ended September 30, 2009, down 5% from $12.1 million for the same period of 2008; and would have been approximately $34.7 million for the nine month period ended September 30, 2009, down 8% from $37.6 million for the same period of 2008.

Expense reduction initiatives that began in early 2008 have allowed the Company to manage costs in nearly all other areas of non-interest expense to offset the increases driven by higher nonperforming asset levels. Salaries and benefit expense decreased $364,000, or 6%, and $1.7 million, or 9% for the three and nine month periods ended September 30, 2009 compared to the same periods of 2008 largely due to staff reductions that occurred in 2008 and a curtailment of bonuses and wage increases in response to the deteriorating economic conditions. We expect controllable expense reduction to continue to improve for the remainder 2009 in response to these initiatives.

Federal Income Tax Expense (Benefit): The Company recorded a federal income tax benefit of $600,000 for the three month period ended September 30, 2009 and federal income tax expense of $2.8 million for the nine month period ended September 30, 2009 compared to federal income tax expense of $639,000 and a federal income tax benefit of $3.1 million for the same periods in the prior year. Federal income tax expense for the three and nine month periods ended September 30, 2009 included a $6.8 and $21.7 million valuation allowance on deferred tax assets as described in the Notes to the financial statements. The impact of the valuation allowance was primarily offset by a tax benefit associated with the net operating loss recorded for each period.

FINANCIAL CONDITION

Summary: In light of the persistent weak economic conditions that began in 2008, management has focused its efforts in 2009 on reducing its loan portfolio in higher concentration areas to improve its financial condition through preservation of capital, improved on-balance sheet liquidity and reduced reliance on non-core funding. Total assets were $1.98 billion at September 30, 2009 a decrease of $167.6 million from $2.15 billion at December 31, 2008. The overall decrease in total assets reflected a decline of $217.2 million in our loan portfolio and $42.9 million in available for sale securities partially used to increase short-term investments by $108.4 million. The decline in assets was primarily offset by a decline in deposits generated through brokers and rate sensitive in-market deposits.

Federal Funds Sold and Other Short Term Investments: The increase in Federal funds sold and other short-term investments to $147.5 at September 30, 2009 was from liquid money market investments held in large, money center banks to improve the liquidity of the balance sheet during this period of economic slowdown. The Company expects to maintain these higher balances until conditions improve and more attractive investment opportunities emerge.

Securities Available for Sale: Securities available for sale were $141.8 million at September 30, 2009 compared to $184.7 million at December 31, 2008. The decrease was primarily due to calls and maturities of approximately $55.3 million of U.S. Government Agency bonds. The additional cash flow has been temporarily reinvested in liquid money market investments as discussed above. As conditions improve, the Company expects to reinvest excess liquidity and selectively build its investment portfolio to diversify its asset quality.

Portfolio Loans and Asset Quality: Total portfolio loans declined by $217.2 million to $1.56 billion at September 30, 2009 compared to $1.77 billion at December 31, 2008. During the first nine months of 2009, our residential mortgage, commercial and consumer loan portfolios decreased by $37.0 million, $169.2 million and $11.0 million, respectively.

While we have seen a decline in our residential mortgage portfolio, the volume of activity in this segment remained strong during the first nine months of 2009. Much of the decline in the residential mortgage portfolio was from refinancing and subsequent sale of loans in the secondary market. Mortgage loans originated for sale were $149.7 million in the first nine months of 2009 compared to $62.4 million for the same period in the prior year. Mortgage interest rates declined in the first half of 2009 as the government responded to weak economic conditions to help spur stimulus into the residential home market. Accordingly, the Company experienced a significant increase in refinancing activity. As refinancing activity has slowed since the beginning of 2009, we expect volumes to moderately decline for the remainder of 2009.

The decline in the commercial loan portfolio in recent quarters reflected the continuing weak economic conditions in West Michigan and our interest in improving the quality of our loan portfolio. In particular, deterioration in residential land development has continued to impact both asset growth and asset quality. The Company has focused its efforts throughout 2009 on reducing its exposure to residential land development loans, diversifying its commercial loan portfolio and improving asset quality. The Company expects continued shrinkage in its real estate development portfolios, primarily residential, to continue to diversify its credit exposure.

Commercial and commercial real estate loans still remained our largest loan segment and accounted for approximately 78% of the total loan portfolio at both September 30, 2009 and December 31, 2008. Residential mortgage loans and consumer loans each comprised 11% of total loans at both September 30, 2009 and December 31, 2008.

A further breakdown of the composition of commercial loans is shown in the table below (in thousands):

	September 30, 2009	December 31, 2008
Construction and Development	$ 195,712	$ 237,108
Commercial Real Estate	638,952	690,525
Total Commercial Real Estate	834,664	927,633
Commercial and Industrial	375,636	451,826
Total Commercial Loans	$ 1,210,300	$ 1,379,459

Commercial real estate consisted primarily of loans to business owners and developers of owner and non-owner occupied properties, secured by single and multi-family residential as well as non-residential real estate. Loans for development or sale of 1-4 family residential properties to land developers were approximately $164.9 million at September 30, 2009 compared to $203.7 million at December 31, 2008. Although it represented a narrow and declining slice of our commercial real estate portfolio, this segment has also been the major source of the Company s asset quality challenges discussed more fully below. Of the total at September 30, 2009, approximately $24.2 million was secured by vacant land, $96.8 million was secured by developed residential land and $43.9 million was secured by 1-4 family properties held for speculative purposes. Vacant land was zoned for residential purposes but with no further development. Developed residential land has been further developed for future residential construction, including but not limited to completed lot surveys, road work, water, sewer and other utility preparation and general land grade. 1-4 family properties held for speculative purposes were on developed residential lots and included completed residential homes or residential homes in the process of construction.

Our loan portfolio is reviewed regularly by our senior management, our loan officers, and an internal loan review team that is independent of our loan originators. An administrative loan committee consisting of senior management and seasoned lending and collections personnel meets monthly to manage the Company s internal watch list and proactively manage high risk loans. When reasonable doubt exists concerning collectibility of interest or principal of one of our loans, that loan is placed in non-accrual status. Any interest previously accrued but not collected is reversed and charged against current earnings.

Nonperforming assets are comprised of nonperforming loans, foreclosed assets and repossessed assets. Nonperforming loans include loans on non-accrual status and loans delinquent more than 90 days but still accruing. Foreclosed and repossessed assets include assets acquired in settlement of loans. As of September 30 2009, nonperforming loans totaled $88.2 million or 5.66% of total portfolio loans compared to $96.2 million or 5.93% at June 30, 2009 and $92.3 million or 5.20% at December 31, 2008.

Loans for development or sale of 1-4 family residential properties were approximately $48.0 million or 54% of total non-performing loans at September 30, 2009 compared to $59.9 million or 65% of total non-performing loans at December 31, 2008. Of the total at September 30, 2009, approximately $1.5 million was secured by vacant land, $31.0 million was secured by developed residential land and $15.5 million was secured by 1-4 family properties held for speculative purposes.

Foreclosed assets totaled $33.4 million at September 30, 2009 compared to $19.5 million at December 31, 2008. Of the $33.4 million, there were 66 commercial real estate relationships totaling approximately $31.0 million. The remaining balance was comprised of 15 residential mortgage properties totaling approximately $2.4 million. All properties acquired through or in lieu of foreclosure are initially transferred at their fair value less costs to sell and then evaluated for impairment after transfer using a lower of cost or market approach. Proceeds from sales of foreclosed properties were $1.3 million and $6.1 million during the three and nine month periods ended September 30, 2009 resulting in a net gain of $4,000 and $113,000, respectively.

The following table shows the composition and amount of our nonperforming assets (dollars in thousands):

	September 30, 2009	December 31, 2008
Nonaccrual loans	$ 83,411	$ 89,049
Loans 90 days past due and still accruing	4,749	3,200
Total nonperforming loans (NPLs)	88,160	92,249
Foreclosed assets	33,419	19,516
Repossessed assets	224	306
Total nonperforming assets (NPAs)	121,803	112,071
Accruing restructured loans (ARLs) (1)	17,060	21
Total NPAs and ARLs	$ 138,863	$ 112,092
NPLs to total loans	5.66%	5.20%
NPAs to total assets	6.14%	5.21%

(1) Represents approximately $12.2 million of commercial loans and $4.9 million of residential mortgage loans whose terms have been restructured. Interest is being accrued on these loans under their restructured terms as they are less than 90 days past due.

Allowance for loan losses: The allowance for loan losses as of September 30, 2009 was $48.0 million an increase of $9.8 million compared to $38.3 at December 31, 2008. The balance of the allowance for loan losses represented 3.09% of total portfolio loans as of September 30, 2009 compared to 2.16% of total portfolio loans at December 31, 2008. Increases in specific reserves on impaired credits and general reserves on the remaining loan portfolio continue to increase the coverage of the allowance as a percent of total loans primarily in response to prolonged weakness in the economy and its impact on real estate valuations securing our real estate loan portfolio.

The provision for loan losses and net charge-offs remained elevated during each quarter in 2009 as we responded to the prolonged weakness in the economy and the resulting persistent and rapid decline in real estate valuations securing real estate loans. Recent appraisals and market trends associated with real estate valuations continue to suggest declines in the value of real estate securing loans. In the current and rapidly changing real estate market, valuation estimates remain fluid and difficult to compile.

The elevated charge-off and provision for loan loss levels continued to be largely associated with the impaired residential land development loan portfolio. For residential land development loans, cash flow to service the debt is primarily expected from sales of lots and properties securing these loans, the velocity of which has declined markedly throughout 2008 and into 2009. This deterioration in cash flows and resulting expected future cash flows was the primary reason for the decrease in the value of the real estate securing these loans and the resulting charge-offs associated with these impaired loans. Despite the challenges associated with these valuations, in previous periods and in the current quarter we feel we have been proactive by diligently charging-off or establishing reserves for impaired loans at levels considered appropriate based upon known information.

The provision for loan losses increased $29.2 million to $52.7 million for the nine months ended September 30, 2009 compared to $23.6 million for the same period of the prior year. Net charge-offs were $43.0 million and $26.5 million for the nine months ended September 30, 2009 and 2008. The ratio of net charge-offs to average loans was 3.43% on an annualized basis for the first nine months of 2009 compared to 2.01% for the first nine months of 2008. Approximately $26.7 million or 62% of the charge-offs for the first nine months of 2009 were from loans for development or sale of 1-4 family residential properties.

Future charge-offs and resulting provisions are expected to be impacted by the timing and extent of changes in the overall economy and stabilization in the real estate markets. There have been signs that may indicate some stabilization in the real estate markets; including recent signs of bottoming in the level of new housing starts and new building permits in the national markets and a slower rate of decline in real estate valuations supporting loans within our real estate portfolio. We have also experienced a decline in non-performing loan levels since December 31, 2008. Non-performing loans were $92.2 million at December 31, 2008, $113.6 at March 31, 2009, $96.2 million at June 30, 2009 and $88.2 million at September 30, 2009. Although these signs are encouraging, we expect it to take additional time for marked improvement in the national real estate markets and in our non-performing and impaired loan levels considering the depth of the economic downturn. There continues to be significant unknowns with respect to the timing and extent of an economic recovery. While we believe our analysis has captured probable losses on impaired loans based upon known information, there can be no assurance that our analysis has identified all of the losses in our loan portfolio.

Our allowance for loan losses is maintained at a level considered appropriate based upon our regular, quarterly assessments of the probable incurred credit losses inherent in the loan portfolio. Our methodology for measuring the appropriate level of allowance is comprised of several key elements, which include specific allowances for loans considered impaired, formula allowance for graded loans, general allocations based on historical trends for pools of similar loan types, and under certain circumstances, reserves related to current market conditions that are pertinent to certain aspects of the loan portfolio.

Overall impaired loans increased to $162.9 million at September 30, 2009 from $151.9 million at December 31, 2008. The specific allowance for impaired loans increased $5.5 million to $25.5 million or 15.6% of total impaired loans at September 30, 2009 compared to $20.0 million at December 31, 2008. Approximately $36.4 million of loans were transferred into an impaired status during the quarter. Approximately 77.6% of these loans were current on their payments at the beginning of the quarter indicating the velocity with which these loans deteriorated. The establishment of specific reserves on these new impaired credits, primarily loans for development or sale of residential properties to residential developers, was the primary reason for the increase in specific reserves.

For impaired loans considered to be dependent solely upon collateral for resolution of the debt, the loan balance is generally charged down to the current estimated value of the collateral net of any selling costs. As a result, there are generally no specific reserves on collateral-dependent impaired loans. Collateral-dependent impaired loans were approximately $54.6 million at September 30, 2009.

We have not grown the residential land development portfolio, but rather reduced our exposure to these loans through charge-off and movement through the cycle from impairment to other real estate owned to ultimate sale. As previously discussed, the portfolio of loans for development or sale of residential properties has declined from $203.7 million at December 31, 2008 to $164.9 million at September 30, 2009. Of the $164.9 million outstanding at September 30, 2009, approximately $64.1 million were classified as impaired of which $48.0 million were in a non-performing status. Impairment writedowns, in the form of specific reserves and previous charge-offs, on these impaired loans have amounted to approximately 35% to 45% of the original loan amount in most cases, and over 60% for certain credits.

The allowance allocated to commercial loans that were not considered to be impaired was based upon the internal risk grade of such loans. We use a loan rating method based upon an eight point system. Loans are stratified between real estate secured and non real estate secured. The real estate secured portfolio is further stratified by the type of real estate. Each stratified portfolio is assigned a loss allocation factor. The lower the grade assigned to a loan category generally results in a greater allocation percentage. Changes in risk grade of loans affect the amount of the allowance allocation.

The determination of our loss factors is based upon our actual loss history by loan grade and adjusted for significant factors that, in management s judgment, affect the collectibility of the portfolio as of the analysis date. The commercial loan allowance was $20.7 million or 1.98% of the total loans within this portfolio at September 30, 2009 compared to $15.4 million at December 31, 2008. The increase in the commercial loan allowance continues to be primarily related to the increase in our recent loss history which resulted in an increase in the allocation factor utilized for certain loan grades.

Groups of homogeneous loans, such as residential real estate, open- and closed-end consumer loans, etc., receive allowance allocations based on loan type. As with commercial loans, the determination of the allowance allocation percentage includes consideration of historical loss trends based on industry and peer experience as well as our historical loss experience. General economic and business conditions, credit quality and delinquency trends, collateral values, and recent loss experience are considered in connection with allocation factors for these similar pools of loans. The homogeneous loan allowance was $1.8 million at September 30, 2009 compared to $2.9 million at December 31, 2008. The decrease was related to a decline in both the total balance of these portfolios and past due status of both the residential mortgage and consumer loan portfolios.

Deposits and Other Borrowings: Because of the decline in assets during the first nine months of 2009, the Company was able to manage a decrease in some of its higher costing deposits. Total deposits decreased $119.5 million to $1.55 billion at September 30, 2009 compared to $1.67 billion at December 31, 2008. The decline was primarily due to a $101.0 million decrease in deposits generated through brokers and a $40.1 million decrease in jumbo certificates of deposit to municipal and other institutional customers. See the Liquidity section below for further discussion regarding our use of brokered deposits. These declines were partially offset by a $28.1 million increase in seasonal checking balances for municipal customers, as well as increases in balances from personal and business checking and savings accounts.

The Company expects its slower asset growth rates and its continued focus on growing core deposits will allow it to further reduce its reliance on brokered deposits. Although the current environment presents challenges for core deposit growth in the near term, we believe that our continued focus on quality customer service, the desire of customers to deal with a local bank, and the convenience of our maturing branch network, will provide growth in our core deposits over time.

Other borrowed funds, consisting of securities sold under agreements to repurchase and Federal Home Loan Bank advances, remained relatively flat during the quarter. The Company has utilized this portfolio as a primary tool in its management of interest rate risk and accordingly, expects this portfolio to remain relatively stable in the near term. In connection with capital raising activities, as more fully discussed below, the Company issued 11% subordinated notes in the amount of $1,650,000 during the second and third quarters of 2009. The notes are non-convertible into common or preferred stock and will mature on August 31, 2017. This subordinated debt qualified for Tier II capital for regulatory purposes.

CAPITAL RESOURCES AND LIQUIDITY

Capital Resources: Total shareholders equity decreased $51.5 million to $97.7 million at September 30, 2009 compared to $149.2 million at December 31, 2008. The decrease was primarily from the $57.3 million net loss the Company incurred in the first nine months of 2009. Cash dividends of $2.9 million were declared on preferred shares during the first nine months of 2009. The Company has continued its temporary suspension of cash dividends to common shareholders to maintain its capital levels during the current economic downturn.

Our total capital to risk-weighted assets was 9.5% at September 30, 2009 compared to 11.3% at December 31, 2008. Our Tier 1 Capital as a percent of average assets was 6.3% and 8.8%, respectively at September 30, 2009 and December 31, 2008. Both ratios continue to be maintained at levels in excess of the regulatory minimums for bank holding companies. The ratios declined since the beginning of the year primarily because of the decline in total capital noted above. The Company s subsidiary bank was considered adequately capitalized at September 30, 2009.

The Company earlier increased its capital through the sale of $31.3 million of Series A Preferred Stock in the fourth quarter of 2008. In the second and third quarters of 2009, the Company increased its capital by $5.9 million through the issuance of Series B Preferred Stock, common stock and the subordinated debt discussed above.

The Company issued 2,600 shares of 9.0% Series B Non-Cumulative Perpetual Convertible Preferred Stock (Series B Preferred Stock) with a liquidation preference of $1,000 per share, resulting in capital proceeds of $2.6 million. The shares are convertible into common stock at the option of the holder at a price per share of $6.00. On or after July 13, 2012, the preferred stock will be subject to mandatory conversion into common stock under certain circumstances.

The Company issued 538,386 shares of common stock at a weighted average price of $3.06 per share resulting in capital proceeds of $1.7 million.

Capital sources include, but are not limited to, additional common stock offerings, preferred stock and trust preferred stock offerings and subordinated debt. The Company remains active at exploring alternatives to increase its capital and is committed to returning to well capitalized status at the Bank level. These activities include further efforts to obtain private capital in the form of common stock, preferred stock and subordinated debt. The Company is also evaluating alternatives to obtain capital through public markets.

If the Company were to continue to incur operating losses or be unable to obtain a sufficient amount of additional capital, the Company may take additional action to preserve capital of the Holding Company by deferring dividends on preferred stock and trust preferred securities.

Liquidity: The liquidity of a financial institution reflects its ability to manage a variety of sources and uses of funds. Our Consolidated Statements of Cash Flows categorize these sources and uses into operating, investing and financing activities.

At the bank level, we focus on maintaining adequate liquid sources on our Balance Sheet to satisfy short-term liquidity requirements and developing access to a variety of borrowing sources to supplement our deposit gathering activities and provide funds for growing our investment and loan portfolios. Our primary sources of liquidity include our borrowing capacity with the Federal Reserve Bank of Chicago s discount window, the Federal Home Loan Bank, federal funds purchased lines and other secured borrowing sources with our correspondent banks, loan payments by our borrowers, maturity and sales of our securities available for sale, growth of our deposits and deposit equivalents, federal funds sold and other short-term investments, and the various capital resources discussed above.

Liquidity management involves the ability to meet the cash flow requirements of our customers. Our customers may be either borrowers with credit needs or depositors wanting to withdraw funds. Our liquidity management involves periodic monitoring of our assets considered to be liquid and illiquid, and our funding sources considered to be core and non-core and short-term (less than 12 months) and long-term. We have established parameters that monitor, among other items, our level of liquid assets to short-term liabilities, our level of non-core funding reliance and our level of available borrowing capacity. We have also developed a contingency funding plan to stress test our liquidity requirements arising from certain events that may trigger liquidity shortages, such as the loss of deposits and other funding sources under extreme circumstances.

We have historically grown our portfolio loans more rapidly than our core deposits. Accordingly, we have relied upon other wholesale funding sources (including brokered deposits, borrowings from the Federal Home Loan Bank and other borrowing sources). We maintain a diversified wholesale funding structure and actively manage our maturing wholesale sources to reduce the risk to liquidity shortages.

In response to recent volatile conditions in the national markets we have actively pursued initiatives to further strengthen our liquidity position. During the first nine months of 2009, we reduced our loan portfolio by $217.2 million and correspondingly reduced our reliance on deposits generated through brokers by $101.0 million and increased our liquid investments by $108.4 million.

Since the Bank was adequately capitalized at September 30, 2009, regulatory approval is required to accept brokered deposits. Because we plan to continue to reduce our loan portfolio and focus on core deposit growth, we expect to generate adequate cash flow to fund the upcoming maturities of brokered deposits and maintain adequate cash reserves. Accordingly, we do not anticipate the need for brokered deposits in the forseeable future. The Bank has not issued brokered deposits since November of 2008. A maturity table of deposits issued through brokers is included in the footnotes.

In addition to strategies focused on improving the liquidity of the balance sheet, the Bank s borrowing capacity from correspondent banks was approximately $252 million as of September 30, 2009. We feel our liquidity position is sufficient to meet our normal and contingent liquidity needs.

The primary sources of liquidity for the Holding Company are dividends from the bank, existing cash resources and the various capital resources discussed above. Banking regulations and the laws of the state of Michigan in which our Bank is chartered limit the amount of dividends our banking subsidiary may declare to the holding company in any calendar year. Under the state law limitations, the Bank is restricted from paying dividends to the Holding Company until its deficit retained earnings has been restored. The Bank had a retained deficit of approximately $14.7 million at September 30, 2009. Throughout 2009, the Holding Company has not received dividends from the Bank and the Company has paid no dividends to its common shareholders.

Based upon existing cash resources, expectations of additional capital from the resources discussed above and a return to profitability, the Company believes it has a prudent liquidity plan to meet its cash-flow requirements.

If the Company were to continue to incur operating losses or be unable to obtain a sufficient amount of additional capital, the Company may have to take additional action to preserve its liquidity including deferring dividends on preferred stock and trust preferred securities.

Forward Looking Statements

This report includes forward-looking statements as that term is used in the securities laws. All statements regarding our expected financial position, business and strategies are forward-looking statements. In addition, the words anticipates, believes, estimates, seeks, expects, plar intends, and similar expressions, as they relate to us or our management, are intended to identify forward-looking statements. The presentation and discussion of the provision and allowance for loan losses, statements concerning future profitability or future growth or increases, and statements about the adequacy of our capital resources are examples of inherently forward looking statements in that they involve judgments and statements of belief as to the outcome of future events. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse affect on our operations and our future prospects include, but are not limited to, changes in: interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Further information concerning us and our business, including additional factors that could materially affect our financial results, is included in our filings with the Securities and Exchange Commission.

Item 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk Analysis

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. Macatawa Bank has only limited agricultural-related loan assets, and therefore has no significant exposure to changes in commodity prices. A more detailed discussion of our exposure to market risk can be found in our December 31, 2008 Form 10-K.

We utilize a simulation model as our primary measurement technique in our interest rate risk management. Our simulation analyses monitors the direction and magnitude of variations in net interest income and the economic value of equity (EVE) resulting from potential changes in market interest rates.

We forecast the next twelve months of net interest income under an assumed environment of gradual changes in market interest rates under various scenarios. The resulting change in net interest income is an indication of the sensitivity of our earnings to directional changes in market interest rates. The simulation also measures the change in EVE, or the net present value of our assets and liabilities, under an immediate and parallel shift in interest rates, as calculated by discounting the estimated future cash flows using a market-based discount rate.

The following table shows the impact of changes in interest rates on net interest income over the next twelve months and EVE based on our balance sheet as of September 30, 2009 (dollars in thousands).

Interest Rate Scenario	**Economic Value of Equity**	**Percent Change**	**Net Interest Income**	**Percent Change**
Interest rates up 200 basis points	$ 77,151	(12.62)%	$ 56,939	(3.77)%
Interest rates up 100 basis points	85,391	(3.28)	57,651	(2.57)
No change in interest rates	88,291	---	59,170	---
Interest rates down 100 basis points	96,785	9.62	58,158	(1.71)
Interest rates down 200 basis points	96,778	9.61	57,837	(2.25)

The above analysis suggests that net interest income will stay within a narrow range over the next twelve months under the differing rate scenarios. Accordingly, the Company s assets and liabilities remain well balanced over the next twelve months.

During the quarter, the Company was able to improve its prospects for net interest income over the next twelve months when compared to the prior quarter primarily from a reduction in rates paid on deposits and expectations for continued downward repricing of fixed rate funding. Accordingly, net interest margin is generally expected to rise from its current level over the next twelve months in all rising rate scenarios. The analysis does suggest, however, that the rise in net interest income will be at a slower pace if rates begin to increase, primarily because of the Company s large portfolio of prime-based variable rate loans that contain floor rates in the range of 4.50% to 5.0%. These floor rates were able to reduce the Company s exposure to a drop in net interest income during the last downward rate cycle. These same floors will limit the Company s ability to increase net interest income when rates begin to rise until the prime rate (currently at 3.25%) reaches these floor levels (i.e. an increase of 1.25% to 1.75%). Time horizons beyond one year result in moderate fluctuation in EVE under the various rate shock scenarios.

Item 4: CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures. The Company s Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the company s disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Form 10-Q Quarterly Report, have concluded that the Company s disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company would be made known to them by others within the company, particularly during the period in which this Form 10-Q Quarterly Report was being prepared.

(b) Changes in Internal Controls. During the period covered by this report, there have been no changes in the Company s internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company s internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

Please refer to the Company s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, (Part II, Item 1 Legal Proceedings) and to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2009 (Part II, Item 1 Legal Proceedings) for information concerning legal proceedings related to Trade Partners, Inc.

As previously disclosed, the Company and Macatawa Bank entered into a Settlement and Release and Stock and Warrant Issuance Agreement and amendments (as amended, the Settlement Agreement) in connection with the legal proceedings related to Trade Partners, Inc. The settlement with respect to a approximately 91% of the number of plaintiffs and the aggregate amount of their claims was completed and became effective on June 17, 2009, as described in Item 8.01 of the Company s Current Report on Form 8-K dated June 16, 2009. On July 27, 2009, the Company completed a second settlement with additional plaintiffs representing approximately 8.7% of the total number of original plaintiffs.

Including both the June 17 and July 27 settlements, the Company paid a total of $5.91 million for the cash portion of the settlement and issued Warrants to purchase a total of 1,478,811 shares of common stock at an exercise price of $9.00 per share. The Company s insurers contributed $950,000 to the $5.91 million cash portion of the settlement.

Following the June 17 and July 27 settlements all plaintiffs have either settled with the Company or have been dismissed. The settlements resulted in the Company eliminating 100% of its potential liability with respect to the Trade Partners litigation.

The Settlement Agreement did not contain any admission of liability or wrongdoing by the Company or Macatawa Bank.

As of the date hereof, except as disclosed above, there were no material pending legal proceedings, other than routine litigation incidental to the business of banking to which we or any of our subsidiaries are a party of or which any of our properties are the subject.

Item 1A. Risk Factors.

The following supplement is provided to the risk factor associated with the Company s ability to pay dividends included in our SEC Form 10-K for the year ended December 31, 2008.

We may decide to defer interest payments on our trust preferred securities which would prevent us from paying dividends on our capital stock until those payments are brought current.

We have not paid any dividends on our common stock since the second quarter of 2008 and do not expect to resume common stock dividends for the foreseeable future. In order to preserve capital, we may decide to defer quarterly payments of interest on our junior subordinated debentures issued in connection with our trust preferred securities. The terms of those debentures permit us to defer payment of interest for up to 20 consecutive quarters. Interest continues to accrue while interest payments are deferred. If trust preferred interest payments are deferred, the terms of the trust preferred securities will prohibit us from paying dividends on all of our capital stock (which includes our common stock, Series A Preferred Stock and Series B Preferred Stock) during the deferral period.

The Company s Form 10-K for the year ended December 31, 2008 also included a risk factor associated with the litigation involving Trade Partners. This litigation has been substantially settled as disclosed in the footnotes to the financial statements included herein.

The following additional risk factor is provided as a supplement to those included in our SEC Form 10-K for the year ended December 31, 2008.

Current and future restrictions on brokered deposits and the conduct of our business could adversely impact our ability to attract deposits or otherwise impact our liquidity and profitability.

As of September 30, 2009, Macatawa Bank is classified as adequately capitalized and is no longer considered well capitalized under banking regulations. As an adequately capitalized bank, federal banking regulations prohibit us from originating or renewing brokered deposits and also restrict the interest rates that we can offer on our deposits. From September 30, 2009 through September 30, 2010, we have approximately $170 million of brokered deposits maturing. If we do not return to well capitalized status, we will not be able to renew these deposits unless we obtain a waiver from the FDIC. If we apply for a waiver from the FDIC, there is no assurance that the FDIC will grant such a waiver. The inability to renew these deposits may adversely affect our liquidity position. For a discussion of our liquidity position, see Capital Resources and Liquidity in our Management s Discussion and Analysis of Results of Operations and Financial Condition.

In addition to the prohibition on originating and renewing brokered deposits, as an adequately capitalized bank we are also prohibited from paying rates in excess of 75 basis points above the local market average on deposits of comparable maturity. Effective January 1, 2010, financial institutions that are not well capitalized will be prohibited from paying yields for deposits in excess of 75 basis points above a new national average rate for deposits of comparable maturity, as calculated by the FDIC, except in very limited circumstances where the FDIC permits use of a higher local market rate. This national rate may be lower than the prevailing rates in our local market, and we may be unable to secure the permission of the FDIC to use a local market rate. If restrictions on the rates we are able to pay on deposit accounts negatively impact our ability to compete for deposits in our market area, then our liquidity could be adversely affected.

There have been no other material changes in the risk factors applicable to the Company from those disclosed in its Form 10-K for the year ended December 31, 2008.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On May 17, 2007, the Corporation announced a repurchase plan that authorized share repurchases of up to $30 million of the Corporation s common stock. The Corporation did not repurchase any shares of its common stock in the open market under the repurchase plan during the first nine months of 2009. The Corporation has remaining authority to repurchase up to $26,103,695 of market value of its common stock under the repurchase plan.

Item 3. Defaults Upon Senior Securities. None.

Item 4. Submission of Matters to a Vote of Securities Holders. None.

Item 5. Other Information. None.

Item 6. Exhibits.

31.1 Certificate of the Chief Executive Officer of Macatawa Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certificate of the Chief Financial Officer of Macatawa Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certificate of the Chief Executive Officer and the Chief Financial Officer of Macatawa Bank Corporation pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this Quarterly Report on Form 10-Q for the quarter ended September 30, 2009, to be signed on its behalf by the undersigned, thereunto duly authorized.

MACATAWA BANK CORPORATION

/s/ Ronald L. Haan

Ronald L. Haan
Chief Executive Officer
(Principal Executive Officer)

/s/ Jon W. Swets

Jon W. Swets
Chief Financial Officer
(Principal Financial and Accounting Officer)

Dated: October 30, 2009

EXHIBIT INDEX

Exhibit	Description
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